BANKING ON THE FUTURE: THE GERMAN BUNDESBANK AS AN AGENT OF ECONOMIC DEVELOPMENT

Current Issue Paper 131

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BANKING ON THE FUTURE: THE GERMAN BUNDESBANK AS AN AGENT OF ECONOMIC DEVELOPMENT

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INTRODUCTION

Central banking institutions have recently received considerable international attention due to their influence over monetary policies. The firmly entrenched position of central banks within the financial structures of the world economy has not spared these institutions from a wide array of challenges to their predominance, especially during a time of world-wide recession. In addition to criticism of the policies followed by the various banks, there has been debate between central banking supporters and free banking proponents, who would abolish central banks. Here in Canada, the effect of the Bank of Canada's policies on the current recession and overall health of the Canadian economy has been much debated. Similarly, the role, and particularly the responsiveness of the Bank to regional concerns, has been a significant issue in recent constitutional debates.

Issues related to central banking have been examined in a 1991 Current Issue Paper by David Rampersad entitled *The Role of the Bank of Canada* (CIP #121). Rampersad's paper describes the historical development of the Bank of Canada and domestic pressures for reforming Canada's central banking system. This paper's focus on the German Bundesbank expands upon Rampersad's brief description of international central banking by assessing the strengths and weaknesses of Europe's leading central bank.

Although the Bundesbank has many responsibilities that are common central bank features, its high degree of independence and power make it an unusual or potentially "futuristic" form of central bank when viewed from the Canadian context. The Bundesbank has been envisioned as a model for a new European central bank (post-1992) and provides a provocative source of ideas for restructuring the Bank of Canada.

In the present Canadian constitutional context, assessing the Bundesbank's potential as a model for a renewed or restructured Canadian bank is a perilous and uncertain task. The Bundesbank emerged in the post-World War II period

through a unique set of historical, cultural and economic circumstances. There are few Canadian equivalents to the financial traumas the German people have experienced in the twentieth century. Fear of economic instability is deeply embedded into the German political psyche and has contributed to the development of the Bundesbank as a powerful national institution that influences all major levers of Germany's financial system (e.g., interest rates, fiscal policy). The basic differences between the evolution of German and Canadian central banks should not, however, diminish the usefulness of examining all available models of central banking to determine whether or not Canada's central banking system provides the most beneficial structure to "bank" future Canadian prosperity on.

This paper initially provides a brief commentary on the challenges facing modern central banking and the criticisms these institutions commonly face in difficult economic times. It then examines the origins, historical development and operations of the German Bundesbank - one of the more successful and influential central banks in the post-World War Two era. Additional sections assess its strengths and weaknesses and highlight the complex relationship between the Bundesbank and the German federal government. The final section of this paper outlines possible lessons for Canada that can be drawn from Germany's central banking experience.

DEBATE ON CENTRAL BANKING

> Of the many elements that bind the countries of the world together, it is the economic that has made itself most evident. In a remarkably short period of time, the realization has grown that no nation, no matter how large or powerful, is able to manage its economy without major reference to events elsewhere . . . Perhaps more so than at any previous point in history, it is clear that economic activity is taking on a form and thrust of its own, indifferent to the efforts of elected governments to influence it, bearing little relation to its origins as "household management."[1]

In an increasingly turbulent world, central banks have been viewed as key institutions in the field of economic policy-making. Their activities as lender of last resort, financial agent for the state and the bodies responsible for monetary policy[2] tend to be utilized by governments to maintain a degree of order within an often chaotic world economy. The ability of central banks to manage their economies, however, has gradually been slipping beyond their direct control in the face of the vagaries of global economic forces. Increasingly, central banks and governments have been under attack for their inability to "properly" manage inflation, interest rates and runaway national debts.

Central banking has been under siege by some academic economists who question its functions and utility. Central banks have also been criticized for operating in an undemocratic fashion, using their discretionary monetary policy to support a deflationary bias (eg. increasing unemployment due to high interest rates in order to fight inflation),[3] and basing decisions on poor information.[4] Free banking enthusiasts have used these arguments to bolster their case for free competition or free trade in the banking field.[5] They argue that competition could produce an efficient money supply structure possibly modelled around the nineteenth century Canadian free banking system.[6]

Defenders of central banking, however, stress that it emerged from free competitive conditions in a natural centralization process. Smaller banks supported the efficiencies gained from centralizing reserves and services. For example, a link to a centralized bank would generally allow smaller banks to receive higher returns on interbank deposits and possibly expand their access to other banking services (e.g., credit cards). In addition, governments need a bank to perform financial functions necessary for the successful operation of the state (e.g., issuing notes, holding deposits, making payments, arranging foreign and domestic loans). Grafting central bank functions onto an existing commercial bank would not have been a popular option, however, since it may have permitted an active bank competitor to regulate, supervise, and potentially control the finances of its rivals. Since it is unlikely that any bank would want its reserves transferred to a competitor playing the role of a central banker, the emergence of non-competitive government supported central banks was hardly surprising.[7]

Although the views of free-banking enthusiasts appear radical in a world where central banks predominate, their criticisms of central banking appear to be increasingly prescient. The extensive power of the German Bundesbank has made it vulnerable to arguments used by free-banking supporters. The Bundesbank's successful economic record and its deeply rooted position in German culture, however, have supported its position as a highly regarded institution within German society.

THE HISTORICAL EVOLUTION OF THE BUNDESBANK

The structure and powers of central banks are shaped by the historical development of their respective countries. The German Bundesbank provides an especially vivid example; German central banking has been shaped by repeated reorganizations in response to major national traumas. In 1875, the Reichsbank became the first central bank to have complete jurisdiction over Germany. Its triumph over free banking was due primarily to the perceived success of central banking in other countries. Although private shareholders initially launched the

bank, it was placed under the legal supervision and management of the German Reich. The bank maintained a high degree of independence since the Reich made no attempt to use its powers of direction.

The character of the Reichsbank was dramatically altered at the beginning of World War One. The German government shattered the bank's independence by legally converting it into an instrument to finance the war effort. The Reichsbank's independent decision-making authority was not restored in the aftermath of the war. Instead, the debt plagued German Reich utilized the bank solely as a source of credit. It was not long before inflationary pressures in the German economy spiralled out of control.[8] The great inflation of 1923 wiped out personal savings, severely distorted the value of pre-war loans, undermined public confidence in the state and contributed to the rise of communist and Nazi political activity.[9] In response to the demands of the victorious powers, the Reichsbank regained its former independence in the Bank Act of 1930. The Reichsbank was stabilized but continually came into conflict with the Reich government over matters related to financial assistance. In one incident, the Reichsbank forced the resignation of a German finance minister. The independence of the Reichsbank was gradually eroded in the early 1930s and formerly abolished by the Nazis in 1937. The Hitler regime created a new *Reichsbank Act* in 1939 and placed the bank in the all too familiar position of war financing. It is hardly surprising that the immediate post-World War Two period was marred by another round of runaway inflation.[10]

The social and political effect of war and inflation has had a profound influence on the German people. The memory of two runaway inflations and the dictatorship that emerged from the Weimar Republic has led to a revival of Germany's long-standing federal tradition and renewed respect for the "rule of law." The Rechtsstaat or "rule of law" refers to a belief that state institutions create and promote a "public good" beyond the interests of market forces. A critical component of the "rule of law" has been a German commitment to a constitutional form of government that extends to both political and monetary activities. These

ideological factors have had a profound affect upon modern German central banking.[11]

In the aftermath of World War Two, the Allies attempted to establish decentralized federal structures in Germany to break its unitary state tradition.[12] A new two tiered central banking system based on the U.S. Federal Reserve structure was established. In every German Land (state), the Allies set up Lander central banks. Due to British insistence, the Bank deutscher Lander (BdL) was also established and became responsible for co-ordinating the activities of the central banks (the BdL was the direct predecessor of the Bundesbank). In response to Allied anxieties related to the political dependence of the former Reichsbank, the BdL was arranged as a body independent of the government. The Allied Banking Commission's veto power (which was never used) over the BdL represented one of the few major differences between the BdL and the future Bundesbank.[13]

The establishment of the new Federal Republic reopened the debate over the future of German central banking. The 1949 German *Basic Law* (Constitution) required the government to replace the Allied legislation governing central banking. During the early 1950s, a major debate erupted over the degree of independence the new central bank should have. The Central Bank Council of the BdL strongly resisted the German government's attacks on the bank's decentralized structure. It was not until 1957 that a political compromise was attained and the Bundesbank replaced the BdL. The *Bundesbank Law* (1957) indicated that the central bank "has the duty to support the general economic policy of the Federal Government."[14] It also stated, however, that the Bundesbank "shall be independent of instructions from the Federal Government."[15] The former provision has tended to have little concrete effect upon the Bundesbank's independence, but has been a source of continual conflict with the government. The main Bundesbank-federal government conflicts tend to emerge when the bank perceives that its constitutionally defined mandate to "safeguard the currency" is being threatened by political manoeuvring.[16]

Although the Bundesbank is not a branch of government, it is part of the legacy of the German constitutional process. The division of powers between the Bundesbank and the federal government are listed in the economic constitution within the *Basic Law* and are a constant point of reference in disputes between the two sides.[17] Although the independence of the German central bank could once again be shattered by simply passing a new federal law,[18] respect for the "rule of law" and the historical legacy of the country have helped the Bundesbank maintain its independence.

THE BUNDESBANK AND THE STRUCTURE OF GERMAN BANKING

The Bundesbank is a legal entity under the ownership of the German Federal Government.[19] Its structure corresponds to the federal system enshrined in the *Basic Law*.[20] The main Frankfurt office is complemented by nine Lander Central Banks[21] and a wide array of branch offices (e.g., North Rhein-Westphalia has 50 branches, Bavaria 32 branches). Fifteen provisional Bundesbank offices have also been set up in the former German Democratic Republic (GDR) after reunification.[22] The Bundesbank exerts a strong and visible presence throughout Germany. In Frankfurt, for example, street signs circling the city point the way to the Bundesbank as if it were some sort of sports stadium.[23] The massive scale of the Bundesbank is quite remarkable. The Frankfurt office alone has over 4,000 employees. The Bundesbank's total staff included over 17,500 employees at the beginning of 1991.[24]

Bundesbank Functions and Duties

The Bundesbank has a monopoly on the issue of bank notes in Germany and regulates the economy's money supply. It is the body responsible for maintaining the solvency of the entire German banking system. As the state bank, it performs both payment transactions and borrowing on behalf of the German government and collaborates with the government in managing its borrowing (e.g., the Bundesbank may purchase government bonds). The Bundesbank administers

Germany's currency reserves and manages the nation's interests in the international monetary system. Although the Bundesbank is heavily involved in business operations on behalf of the state, legal restrictions prevent most borrowing activities between the two parties. The only exception involves financing for short-term budget deficits.[25] The maximum amount of short-term credit available to the government has been strictly limited to prevent the Bundesbank from being "exploited" by the German state.[26]

Central Bank Council

The Central Bank Council (CBC) is the most important decision-making structure in the Bundesbank. Council activities include devising the Bundesbank's monetary and credit policies, setting guidelines for the bank's business and administrative operations, and occasionally sending instructions to the Bundesbank's administration.[27]

In keeping with Germany's federal character, the principle of "one Lander one vote" applied to the CBC until the spring of 1992.[28] Reunification has led to the merging of several small Lander banks in order to streamline the operation of the CBC.[29] The Bundesbank President and Vice-President are now joined on the council by up to eight additional members of the Frankfurt Directorate and nine Lander Central Bank Presidents appointed by Lander governments. Although the government's powers include the right to appoint directors to the CBC, the council's federal composition tends to reduce the risk of political influence being a major factor affecting the Bundesbank's daily operations. The council meets every two weeks and makes decisions on the basis of a simple majority vote.[30]

The CBC has placed the Bundesbank in conflict with the German federal government on numerous occasions. The source of the friction tends to lie in reconciling the Bundesbank's legally defined role to secure the lowest possible inflation rate with governmental policies aimed at employment levels and economic growth.[31] CBC decisions often receive major press coverage since the

bank's actions can have an effect comparable to the government's economic policy decisions. On occasion the government's economic and fiscal agenda can be virtually vetoed by the CBC. Within the Bundesbank organization, however, the council is very democratic and follows parliamentary rules.[32]

Central Bank President

The Bundesbank presidents' highly regarded domestic and international standings give them considerable clout in financial matters related to the German and world financial markets. However, the high profile nature of the presidential position does not change the fact that he/she needs to gain a consensus in the Central Bank Council (CBC). Presidents have only a limited role in the internal decision-making of the bank since they possess only one vote in the CBC. A successful record of consensus building raises the stature of the Bundesbank president while a rift with the council can doom an international agreement or domestic policy.[33]

Frankfurt Directorate

Frankfurt Directorate members must be nominated by the federal government and then appointed by the Federal Republic President. Directors are appointed for at least eight year terms and must have "special professional qualifications" (undefined in the *Bundesbank Law*).[34] The president, vice-president and directors of the Bundesbank cannot be removed during their terms of office. The rationale behind the lengthy terms appears to be an effort to separate the appointment of top Bundesbank officials from parliamentary elections.[35] These periods of appointment are twice the intervals of state and federal elections.[36]

The Frankfurt Directorate runs the day to day activities of the Bundesbank. This includes a wide range of administrative and analytical tasks as well as an increasing number of daily market interventions. The directorate is divided into five divisions: (1) Treasury, Buildings, Administration and Personnel, (2) Statistics and National Economy, (3) International and Foreign Divisions,

(4) Organization and Bookkeeping, (5) Banking, Minimum Reserve and the Berlin Administrative divisions. Credit activities have been placed under the direction of the Frankfurt Directorate vice-president while Public Relations, Supervision and Legal Divisions are under the president's management. Lander Bank presidents tend to be critical of the executive nature of the Frankfurt Directorate's daily operations and are suspicious of directorate staff responsible for executing CBC policies.[37]

Lander Central Banks

Lander Central Banks (LCB) act as the main administrative branches of the Bundesbank within the Lander. Under German public law, administrative dealings with the Lander governments and transactions with local banks are the responsibility of the LCBs and their branch offices. The main LCB offices typically possess the following divisions:

- Credit Division - administers credit activities of the LCB and ensures that local bank branches follow the Bundesbank's interest rate policies.
- Banking Division - supervises private bank operations and reports irregularities.
- Economic Division - observes and analyzes important economic and monetary trends in the Lander and reports them to the LCB President.
- Statistics Division - collects and analyzes data for the LCB.
- Foreign Currency Division - tracks investments in the Lander by residents using foreign currency and non-residents using Deutschmarks.
- Bond Division - supervises security transactions and the credit requirements of the nation.
- General Administration Divisions - provide personnel, accounting, and legal services for the LCB.

The LCBs also serve as "listening posts" or information gatherers in the Lander. They have a managing board that handles daily activities and advisory boards

made up of appointed local business, agriculture and labour interests. The advisory boards are purely consultative bodies designed only as a source of expert advice. The skill level of the LCB president will largely determine whether the views of the advisory board are ever heard at CBC meetings.

In contrast to the Canadian system of federal appointments to the Bank of Canada, all LCB presidents are appointed by their respective Lander governments for eight-year terms. Due to the diversity of parties that tend to gain power in federal and Lander governments and the staggered nature of parliamentary elections across all levels of German government, the federal government is unlikely to gain any sudden influence upon the composition of the CBC.[38]

The Bundesbank Budget

The Bundesbank's budget is not part of the government's overall budgetary process. The Central Bank Council sets the Bundesbank's budget and the figures are published in the Bundesbank's annual income statement. In the past, the Bundesbank has shifted up to 30% of its annual profits into reserve pools. In recent years, however, only small contributions have been made to these reserves. Nearly all of the profits (98% in 1984) were directed to the central government.[39] The Bundesbank was not happy about its role as a major generator of money for the government (12.9 billion DM transferred in 1984). It was afraid that the extra central bank money would have inflationary effects. The Bundesbank has subsequently ended its lump sum payments to the government and replaced it with more controlled instalments.[40]

Germany and Universal Banking

The massive scale of the German Bundesbank can obscure the fact that commercial and non-commercial banking sectors also exist and have played a critical role in Germany's post-war economic resurgence. Germany possesses one of the most liberal and diversified banking systems in the world. Under the

German universal banking system, any institution that conducts a "banking activity" is defined as a bank. Legal banking activities include handling deposits, consumer and commercial lending, securities-underwriting and trading, mutual fund activities and investment counselling. A banking license allows any entity to hold large equity shares in commercial, industrial and insurance companies. The only restriction is that all of these activities must be handled by different departments of the same bank.[41]

Approximately 300 commercial banks exist in Germany. The Deutsche, Dresdner and Commezbank, however, are the three largest financial institutions and dominate the German banking environment. These three universal banks concentrate on retail and wholesale banking, securities trading and underwriting, and insurance activities.[42] Although the "big three" accounted for 41% of commercial banking assets in 1980, they only controlled 10% of total banking assets. Surprisingly, the highly developed non-commercial sector of mortgage banks, building and loan associations, savings banks, credit co-operatives and specialized institutions control 76.4% percent of total bank assets in 1980.[43] These "banks" tend to serve regional or specialized needs or both.[44]

Germany has a long tradition of close relationships between banks, the state and industry. It has been described by academics as either a system of "finance capitalism" or "state investment planning." Banks have been critically important in German industrial finance. Firms have had to rely heavily on bank loans to support their activities since shares and bonds have provided only a minor source of funds. There is a banking presence on the supervisory boards of many of the top 100 German companies and this has a significant influence on the overall direction of industrial development. German banks are hesitant to supply funding for short-term profit situations and prefer to mobilize resources for firms positioning themselves for long-term market shares. The German banking elite recognizes that their country is resource poor and is dependent on export revenues for its survival. Their underlying philosophy is to mobilize the capital and trade credits necessary to provide an environment for long-term success as an exporting

nation. This philosophy permeates all levels of German banking including the Bundesbank.[45]

Germany's tradition of universal banking has been subject to very few restrictions.[46] Even its deposit insurance system is voluntary and private.[47] More surprisingly, close ties between the Bundesbank and the German commercial banking sector do not appear to have been controversial even though the Bundesbank is responsible for regulating the solvency of the overall banking system.[48] The fact that the last two Bundesbank presidents (their terms stretched from 1970-1991) both came from major institutions within the German banking community provides an excellent example of the close Bundesbank-commercial banking relationship.[49] As Kenneth Dye's study of German banking suggests, the intensity of the Bundesbank's regulatory scrutiny may be influenced by the ties between the banking community: "The Bundesbank is one of the most autonomous and powerful central banks in the world ... Yet the role of the Bundesbank as regulator is secondary to that of acting as a high-level spokesman for the banks in Bonn."[50] The close relationship between the conservative and constitutionally based Bundesbank and the underlying liberalized banking system is one of the more unusual features of the German banking structure.

POWERS OF THE BUNDESBANK

The *Basic Law* provides the foundation for Germany's national economy. Both the monetary and the credit powers of the Bundesbank are part of the economic constitution included within the *Basic Law*. The economic constitution is itself made up of three parts. The *Bundesbank Law* of 1957 gives the central bank its monetary authority and appears intended to insulate it from political pressure. Complementing the Bundesbank's monetary authority is the *Credit Law* of 1961 which established the Federal Credit Regulatory Agency (FCRA) as the organization responsible for supervising German banks. The FCRA is an autonomous body within the German Ministry of Economics and has independent policy powers over the German banking industry. FCRA oversight activities are

only brought to the Bundesbank's attention if it uncovers problems serious enough to detrimentally affect the whole economy. In other words, the Bundesbank's regulatory responsibilities for banks lie in the macroeconomic sphere while the FCRAs regulatory activities deal with microeconomic concerns within individual German banks. The FCRA is legally bound to obtain the Bundesbank's approval of liquidity regulations and to manage the banking industry in a manner supportive of Bundesbank monetary policy.[51]

The final element of the economic constitution is the 1967 *Stability and Growth Law*. This law is based on the Keynesian belief that economic growth could produce an uninterrupted increase in living standards. An independent Council of Economic Advisors has been created within the Finance Ministry to promote state interventions for a balanced relationship between inflation, trade and employment. The council advises government on monetary matters and creates an annual report for the Chancellor. It has no authority over German monetary policy and simply forms another source of expert advice the government must consult. Public faith in the stability law was shattered in the economic downturn of the 1970s and has subsequently led to efforts to achieve stability on more "realistic" terms.[52] In other words, the *Stability and Growth Law* does not impede the Bundesbank from pursuing the economic direction of its choice.

Bundesbank legislation provides the bank with four mechanisms through which to influence the German economy. The interest rate levers are the discount rate and the Lombard rate.[53] The discount rate provides the benchmark at which the Bundesbank lends money to banks, while the Lombard rate governs loan charges for short-term bank financing (e.g., balancing overnight bank deposits).[54] Both rates are designed to influence interest rates and money markets over the long-term. Unlike some other central banks, the Bundesbank can only influence financial markets indirectly since it does not have direct control over interest rates or credit ceilings. The Bundesbank also influences the economy through open market transaction devices (e.g., short-term bond transactions, sales of treasury bills, foreign currency swaps) and minimum reserve policies. Open market

transactions offer more flexibility than all of the Bundesbank's other intervention options, but they can also produce unwanted public exposure leading to negative economic side effects (eg. foreign retaliation).[55]

BUNDESBANK-GOVERNMENT CONFLICTS

Conflict has characterized efforts to reconcile the Bundesbank's role as "protector of the currency" with government initiatives supporting economic growth and employment. Since the 1970s, conflicts have intensified due to the increasing difficulty of maintaining strong economic growth.[56]

The Bundesbank's tradition of battling inflation has not been favoured by everyone. Konrad Adeauer, the first German Chancellor, complained about the negative effect the anti-inflationary policies of the former Bank deutscher Lander (BdL) was having on reconstruction in the immediate post-war period.[57] This BdL legacy has been maintained by the Bundesbank and is contributing to similar outpourings of frustration today. The anti-inflation consensus within the population appears to be starting to weaken as a new generation of Germans are beginning to fear unemployment as a worse evil than inflation. The recent influx of East German workers into a reunified Germany may strengthen this sentiment over time, and place pressure on the Bundesbank to work harder to achieve the Stability Act's goals of full employment and economic growth. The Bundesbank has also been criticized for the expense and size of its massive federal structure. These critics would like to see the Bundesbank rationalized on the lines of the U.S. Federal Reserve Board which possesses only 12 regional offices.[58]

German public law depicts the relationship between the Bundesbank and the federal government as a set of rights and duties. Political leaders in Bonn do have some powers over the Bundesbank's policy-making activities. The directors of the Central Banking Council (CBC) are appointed by the Federal President and members of the cabinet can attend sessions of the council. Government officials cannot vote in the CBC but they can make proposals and suspend a central council

decision for up to two weeks. The Bundesbank must advise the government on monetary policy matters and supply it with any information it needs. The Bundesbank is not, however, subject to any review or control by the Bundestag (German Parliament) and it can be a serious constraint upon elected governments. Despite being bound to support the government's economic policies, the Bundesbank can determine the final nature of that support. It can also make its views known to the public. In Bundesbank publications, through the press and behind the scenes it works to achieve its goals. The Bundesbank's independent monetary decision-making can affect the state of the economy and pose immediate political dilemmas for the ruling government.[59] The following examples will highlight these points:

- In 1965-66 the Bundesbank raised the bank rate from 3 to 5% against the wishes of German Chancellor Edhard. The Bundesbank raised its rates to fight the inflationary impact of Edhard's pre-election gifts to the voters. The recession which followed was deepened by the central bank intervention and led to the resignation of the Chancellor. It would appear that the Bundesbank was partly responsible for the economic crisis which led to Edhard's demise.

- A controversy surrounding a revaluation of the German Deutschmark became a major election issue in 1969. The German Social Democrats (SPD) and the Bundesbank argued that a revaluation was necessary to stop an influx of dollars into Germany while Chancellor Kiesinger, his Minister of Finance, and German industry claimed that the revaluation scheme would be a disaster for German exports. The Bundesbank's explicit support of the Social Democrat's revaluation plan helped raise the SPD to power at the expense of the governing Grand Coalition.

- Between 1979 and 1982, the Bundesbank prevented the Social Democrat government of Helmut Schmidt from stimulating the economy by keeping the price of investment capital at artificially high levels through its stubborn commitment to high bank rates. Tensions within the Schmidt government over taxes and spending were exacerbated by the Bundesbank's hard line and finally led to the coalition's breakup. After the Schmidt government lost power, the Bundesbank lowered interest rates.[60]

- In the 1990 pre-election period, Bundesbank directors made public appearances throughout Germany to warn the Kohl government that it could not finance reunification with borrowed money. They advised the government to either raise taxes or slash spending. The Bundesbank made

sure it had Kohl's attention by raising interest rates a month before the election[61]

Continuity and Change

The independence of the Bundesbank has helped it attain a central role in German politics. The bank continues to cling defiantly to its independence in the face of major political confrontations with the central government. Recently, however, serious challenges to the Bundesbank's coveted independent status have emerged. Increased political interference in Bundesbank operations (e.g., politicized appointment procedures for LCB presidents),[62] shifts in public opinion against its policies, the global effect of economic integration, and events surrounding the demise of Soviet communism are all placing major strains upon the bank. Its reaction to these pressures tends to follow historically embedded patterns, for example, maintaining a low inflation rate while giving little thought to potential adverse consequences. The Bundesbank's response to these challenges is highlighted most effectively through the activities of its recent presidents.

The Bundesbank has been characterized by tremendous continuity in its senior personnel and a stubborn single mindedness to achieve its goals. Part of the power of the Bundesbank has been derived from the aggressive nature of its past presidents. Karl Otto Pohl was the Bundesbank president from 1980 to 1991 and exerted the bank's influence around the world. An excellent example of the stresses that Pohl and the Bundesbank could produce in world markets occurred in 1987. A public squabble between U.S. Treasury Secretary James Baker and Pohl over the Bundesbank's monetary policies (eg. high interest rates - slow growth) sparked the 1987 stock market crash. Baker's threat to let the American dollar fall below the G-7 range if Germany did not lower its interest rates, publicized a serious rift in the G-7. The unintended side effect of the Bundesbank's defence of its domestic interests was the significant role it played in pushing the world's stock markets into a financial melt down.[63]

The stock market crash of 1987 may have marked the pinnacle of influence attained by both Pohl and the Bundesbank. Recent German chancellors have had an increasing amount of success in drawing the Bundesbank into endeavours it does not formally support. In the late 1970s, Helmut Schmidt managed to drag the bank into the European Monetary System by failing to tell the defiant Bundesbank about his plans until it was too late. Helmut Kohl has subsequently drawn the Bundesbank into a joint Franco-German finance council in which the German bank President is outnumbered by politicians. Kohl also announced plans for a German monetary and economic union a day after Pohl had publicly spoken out against the idea.[64] Pohl has since described the introduction of the German Deutschmark into former German Democratic Republic (GDR) territory as a planning "disaster."[65] The Bundesbank has to deal with the continuing slide of the former East German economy, plagued by increasingly serious unemployment and bankruptcy. Germany's fiscal policy was badly shaken in 1991 by a 92 billion dollar public sector transfer to the eastern sector.[66]

Further complicating the current situation are efforts to create a European Central Bank. Not surprisingly, Pohl has serious reservations about this endeavour as well. Since the Bundesbank already has de facto preeminent control over the European economy as supplier of the lead intervention currency, its desire to join the European monetary bandwagon has not been especially strong. Pohl's recognition of the political reality that some such bank is envitable led him to work towards ensuring that the new European bank is created in the Bundesbank's image.[67] He has demanded that the new bank be fully independent of political interference and that members of its governing body be personally and politically independent. The bank must have a monopoly over the creation of money in Europe and be constitutionally forbidden to relieve government deficits by printing money.[68] Pohl's demands reflected his obvious fear that the German government will accept a French scheme to have some sort of political influence present within the new central bank.[69]

Unrest in the Bundesbank extends beyond the future European Monetary Union and even the major upheaval caused by reunification. A reform plan within the Bundesbank itself has caused all sorts of problems. The future addition of five new Land directors from the reunified territory threatens to disrupt the rough director/Land parity of the CBC council. Maintaining the balance would require a council of 32 members. In Pohl's opinion this is "federalism gone mad."[70] His problems in gaining a consensus among his existing 18-member board led him to try unsuccessfully to pass a plan to streamline the council to eight provincial posts. Pohl's recent resignation for "personal reasons" came mid-way through his term (May 1991) and was seen to be related to the turbulent relationship the bank has experienced with the Kohl government.[71]

Former Bundesbank vice-president Helmut Schlesinger has replaced Pohl as the bank's interim boss and is expected to hand over this position in 1993 to his deputy, Hans Tietmeyer.[72] Under Schlesinger's leadership, the Bundesbank appears to be heading along its traditional path. As *The Economist* has indicated, the continuity within the Bundesbank is hardly surprising: "Germany runs its monetary policy by law, not by man. Its low inflation rate has had more to do with the Bundesbank's constitution than with the qualities of the four men who have held its top job."[73] Schlesinger is faced, however, with a shrinking current account surplus, borrowing needs of up to $110 billion and a shrinking economy in eastern Germany.[74] Government support for the unemployed in the east and huge trade credits for the former Soviet Union and other Eastern European nations are fuelling Germany's budget deficit. Even the Bundesbank's leadership role over European monetary policy may soon be challenged by an increasing number of European states with lower interest rates.[75]

Increasing levels of political activity within the Bundesbank have likely been the cause of at least part of the problems within the bank's decision-making apparatus. Although the inner directorate has remained fairly removed from political influence, this has not been the case with the Lander directors. At the Land level,

party politics has had an extremely significant influence over the appointment of Land presidents, resulting in some poorly qualified candidates.[76]

Schlesinger has at least managed to settle the Bundesbank's internal restructuring problems that were inherited from Pohl's administration. The German Bundesrat has recently approved a government proposal to cut the number of Lander central banks from 11 to nine, instead of accepting proposals to raise it to 16. It appears that the cut in the number of Lander banks is based on the Bundesbank's desire to avoid making its Central Bank Council too large.[77]

Obviously it is desirable for the Bundesbank to settle its own internal problems at a time when it must deal with the effect of major economic and political problems within the newly expanded German federation. Serious problems may develop, however, if the Bundesbank reacts too strongly to protect its own domestic interests.

On the eve of France's vote for entering the Maastricht Treaty on European monetary union, currency chaos hit the European monetary system and world currency markets after investors reacted with "disappointment" to a minimal decrease in the Bundesbank's Lombard rate (9.5% from 9.75%). Short-term interest rates in Sweden, for example, rose to a staggering 500%. The currency instability also was the catalyst behind Britain pulling out of the European Monetary System's Exchange Rate Mechanism[78] (a system of exchange rate bands - EMS member countries intervene to stabilize member currencies if they fall outside of a specified band).[79] The Bundesbank's efforts to limit post-reunification inflation provides the most likely explanation for the bank's hardline approach to interest rate matters.[80] It appears that the recent currency crisis has placed the Bundesbank under increasing international pressure to look beyond its own narrow interests when it makes major economic decisions.

The Bundesbank's current problems cast only a small shadow upon its very successful history role in the economic development of Germany. It has had a

remarkable record of combatting inflation. On the fortieth anniversary of the 1948 Deutschmark currency reform, the Bundesbank issued a statement stressing 40 years of economic success with an inflation rate averaging 2.7%.[81] Even in the "bad days" between 1978 and 1988, the German inflation rate averaged only 3.3%.[82] As protector of the currency and monetary sovereign, the Bundesbank would undoubtedly interpret these types of results with considerable pride. Its role in maintaining a stable currency in the face of post-war reconstruction and economic uncertainty was no small feat. The Bundesbank's involvement in West Germany's post-war boom is also undeniable. It helped create a stable economic environment which supported an export oriented growth rate described as "inconceivable" without the existence of an efficient central banking system.[83]

The West German economy experienced virtually uninterrupted growth between the currency reform of 1948 and the oil shocks of the early 1970s. Although the pace of growth slowed and even declined through the recession of the early 1980s, the growth rate jumped up to a yearly average of 2.4% from 1983 to 1988.[84] Even during the "rough" years from 1970 to 1983, Germany maintained between 10 to 12% of the world's merchandise export trade[85] (one-third of West Germany's GNP was exported).[86] In the opinion of *The Economist*, the lesson the Bundesbank experience has offered to the world is that "an independent central bank, instructed by parliament 'to safeguard the currency,' will produce macroeconomic stability that no government-controlled version ever does."[87]

The Bundesbank has been far from immune to domestic and external pressures. The current range of challenges facing the bank will undoubtedly severely test the mettle of this world renowned institution. Although the impact of global economic forces and European integration may lead to the elimination or restructuring of the Bundsbank by the mid-1990s, the German people will likely not agree to "bank" their future on a European Central Bank that does not strongly resemble the Bundesbank model.

THE BANK OF CANADA: OPTIONS BASED ON THE BUNDESBANK

Although press coverage has been given to the free-banking idea of privatizing the Bank of Canada,[88] it appears to be receiving little consideration in policy making circles. Of greater significance are increasingly common criticisms of the Bank of Canada's structure and operations. Banking analysts have criticized Canada's central bank for its patronage style appointment of directors who are not even financial experts[89] and the centralization of "all-but-total power over bank rates and exchange . . . in the hands of one person - the Governor of the Bank of Canada, whose unilateral fiat determines whether companies can afford to borrow, whether export industries will thrive or falter."[90] In addition, the Bank of Canada's recent success in lowering the nation's inflation rate has failed to mute criticisms that the bank's inflation fighting measures may have contributed to high unemployment levels and record personal and business bankruptcies.[91]

It is important to think about a wide range of concerns when contemplating future changes to the Bank of Canada. The bank's monetary direction will have an important influence on wage levels, unemployment, and the future economic development of the country. Will the views of the general population have any place in the decision-making process? What level (if any) of independence should the central bank possess? Some commentators have looked to other banks, including the German Bundesbank for alternative models or lessons for reforming the Bank of Canada.

Lessons from the Bundesbank

The German Bundesbank provides several important alternatives to the Bank of Canada model. The vast, decentralized structure of the bank gives it a strong presence throughout all of Germany. The numerous branch offices provide far greater information and statistical gathering services than are present within the system of Canadian nine regional offices. Better information tends to lead to improved decision-making. The German model is more accessible to the

population through its physical presence and its LCB advisory board system. The appointment of Lander Central Bank presidents tends to add a strong regional voice to the central bank's decision-making process that is equal to the actual power of the Bundesbank president. These regional entities are also responsible for implementing a considerable portion of Bundesbank policies.[92] The demand for greater regional representation in Canada's central banking system is among the most pressing calls for reform[93] and the Bundesbank is a very positive example of an effectively functioning regional system. The U.S. Federal Reserve system of regional offices provides a further example that a decentralized central bank can be applied successfully to a large geographic area.[94] American Federal Reserve Banks are more likely to reflect regional interests than their Canadian counterparts since they are actually owned by their member banks. In addition, member bank representatives outnumber those named by the U.S. Reserve's board of governors on each Reserve Bank's board of directors.[95]

It is important to stress the limited (one vote) power of the Bundesbank president in comparison to Bank of Canada governors, who have never faced a serious challenge from other directors to their views on policy matters.[96] Once the German Central Bank Council has made a decision, however, the Bundesbank has far greater independence to carry it out than a Bank of Canada governor. The Canadian governor must consult regularly with the minister of finance and is subject to the power of the finance minister's ministerial directive.[97] The influence of ongoing private consultations appears evident in the well-aligned positions frequently taken by the Bank of Canada governor and the minister of finance.

The most convincing test of the Bank of Canada's limited independence may be the fairly high inflation rate Canada has tended to sustain over the last two decades. Research has indicated that stronger levels of central bank independence correspond to lower inflation rates and greater price stability.[98] Independence is enhanced in countries where central banks have the legal authority to set and implement monetary policies, bank directors appointed by non-central government

bodies for lengthy tenures and limits on central bank financing of government debts.[99] These characteristics are strong features of the Bundesbank.

In the Canadian case, the ability of the minister of finance (with cabinet approval) to appoint the governor and senior deputy-governor for seven-year terms,[100] and the bank directors for three-year terms,[101] has been subject to considerable criticism. Beyond simple patronage concerns are questions regarding the appropriate number of government appointments (if any), and the acceptable length of terms. The German system limits federal government appointments to only the executive positions and utilizes eight-year terms (average stay is about ten years) to help decouple the appointment process from governments' electoral fortunes.[102]

Unlike the Canadian central bank, the German system has no bias against directors being from the banking community. Although conflict of interest concerns might pose a problem for the application of this German practice within Canada, it may still be possible to utilize experts from the Canadian banking community as Bank of Canada directors if they were given full-time positions at a higher salary (currently $3000 per annum plus meeting fees and expenses).[103] In Germany, central banking takes on a more business-like tone. Directors are full-time, have real power, and meet every two weeks to deal with important financial concerns of the nation (Canadian directors meet at least four times a year).[104]

Many commentators argue that the *Bank of Canada Act* of 1930 is outdated and in need of a major overhaul. Its focus on the external value of currency and the use of monetary policy to stabilize the business cycle has not kept up with central bank intervention strategies.[105]

The German Bundesbank provides an example of a central bank with its primary mandate and independence constitutionally defined. The bank has had a strong sense of purpose and a very high degree of political legitimacy even when faced with attacks from the German federal government. The Bundesbank also indicates

that it is possible to have a very liberal universal banking system operating in conjunction with a highly conservative central bank.

Important factors contributing to the Bundesbank's successful history are its emphasis on ensuring strong regional input into its decisions and the presence of clear constitutionally mandated instructions for the central bank to follow. In contrast, the Canadian system appears to be influenced to a higher degree by political interference than its German counterpart and has a far more ambiguous legal basis.[106] The Bundesbank's committee structure has played an important role in ensuring that Lander feel part of the bank's decision-making process. Lander involvement in the implementation stage, through the ability of LCB presidents to send directions to the Frankfurt Directorate, also gives these bodies a more "hands-on" role in the Bundesbank's activities.[107] Questions regarding the appropriate way of dealing with increasingly high levels of daily central bank economic interventions, however, need to be reconsidered in both the German and Canadian cases.

The German Bundesbank system is not without its drawbacks. It has not been an economic panacea: there remain very significant regional disparities and the reunified nation is facing serious challenges dealing with the needs of the former German Democratic Republic. The Bundesbank structure is a massive, expensive and very bureaucratic organization that tends to resist change. Its ideological outlook has a major effect on levels of employment, wages and economic growth in Germany. The Bundesbank can be a serious constraint on the German central government's foreign and domestic policy endeavours and can literally veto major policy decisions of elected governments. It is not uncommon for the Bundesbank to challenge publicly government economic policies even to the point of taking actions that may imperil the electoral fortunes of the governing political party. Whether these types of powers should be wielded by a body with little direct political accountability is a matter of considerable concern to some observers.

From a comparative viewpoint, the powers of the Bundesbank are far more impressive than those possessed by the Bank of Canada. The basis for the Bundesbank's power is derived from more than just its legal mandate. The bank's real strength has been tied to its ability to maintain a high level of public support.[108] Germany's history and post-war economic success have been critical factors in enhancing the bank's popular image. Politicization problems in the Bundesbank and growing public dissatisfaction with the current state of the German economy, however, have been threatening to erode the strong consensus that has buttressed the Bundesbank's legitimacy since its inception. Any effort to reshape the Bank of Canada in the Bundesbank's image should carefully balance the German bank's highly touted past with criticisms that have recently become more pronounced.

Similarly, when considering the possible application of Bundesbank principles to Canada, it is important to remember the simple idea that people tend to base their views and expectations on their own historical experience. Introducing a new Bundesbank style framework may lead to far different public reactions and expensive adjustment processes than have been encountered in Germany.[109] Pressures from the international economy will also have an unpredictable effect on a central bank's decision-making.

CONCLUSION

The Bundesbank has provided strong and stable financial leadership for the German economy. It has been a well respected and highly praised organization in the views of most foreign and domestic observers. As an agent of economic development, the Bundesbank's influence is clearly evident in the post-war German economic success story. The Bundesbank's recent vulnerability to criticisms comes in the wake of a wide array of exceptional challenges, from the economic dislocations of reunification to global recession. When consideration is given to the strength of the economic and political forces the bank has had to deal with, the Bundesbank has adjusted remarkably well and managed to keep its

legitimate status intact. The Bundesbank model has provided the world with an example of the potential benefits of a decentralized and strongly independent central bank. Although the Bundesbank has been only one factor among many shaping Germany's economic fortunes, it provides a model of success that a wider European community may "bank" its future prosperity on. Potential applications of the Bundesbank model within the Canadian federation should be tempered by considerations regarding its compatibility with the historical evolution of Canada's political economy.

FOOTNOTES

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